METALS & MINING | Q2FY23 Preview | 10 October 2022

Weak quarter; look for margin stabilisation in H2

- **Expect Q2 EBITDA to drop over 50% QoQ for Indian steel majors as margins fall well below mid-cycle levels**
- **Margins likely to bottom out in Q2; we await management inputs on pace of demand pickup and risk of coking coal price increase**
- **Prefer defensive play TATA (BUY, TP Rs 140) in the current volatile environment**

Kirtan Mehta, CFA
research@bobcaps.in

Sharp drop in EBITDA: We expect our steel majors coverage to collectively post a more than 50% QoQ decline in Q2FY23 EBITDA, driven by sharp margin compression as the drop in steel price has not been offset by decreases in coking coal costs.

Volumes revive but inventory build-up continues: For the four majors under our coverage, we expect domestic sales volume to recover 20% QoQ supported by market share gains from secondary producers as sector is experiencing nearly flat QoQ volumes. Despite recovery, inventory buildup has continued with stocks rising to 9.5mt by end-August from 8mt at end-June, as per the Centre for Monitoring Indian Economy (CMIE).

Record low margins likely: We estimate that EBITDA per tonne will decrease by Rs 8.6k QoQ on average for the four majors to Rs 5.5k, significantly below the mid-cycle level of Rs 10-15k. We forecast a sharper decline for TATA's India operations this quarter due to increased usage of high-cost coking coal. Amongst our coverage, SAIL is likely to post the lowest EBITDA/t at Rs 2.4k with higher operational gearing.

Margins to bottom out: We expect steel margins to start recovering from Q3 led by a drop in coal cost, increase in sales volume and gradual recovery in prices. Coking coal costs have eased from US$ 440/t (average) in Q2 to US$ 250-300 levels but face upside risk. Domestic demand remains healthy and is likely to rise post festive season. We are also seeing initial signs of price increase in early October.

Key monitorables: We will watch management commentary for the pace of domestic demand improvement, near-term potential for exports in a scenario of duty removal, time needed for inventory normalisation, ability to push price hikes in domestic markets, risk of increase in global coking coal prices during Australia's wet season, and stabilisation levels for domestic iron ore/pellet prices.

Constructive on Indian ferrous players: We remain constructive on Indian ferrous players as we look beyond near-term uncertainty and focus on delivery of the next wave of expansion. Defensive play TATA (BUY, TP Rs 140) remains our top pick.

Recommendation snapshot

Ticker	Price	Target	Rating
JSP IN	447	460	BUY
JSTL IN	666	655	HOLD
SAIL IN	82	90	HOLD
TATA IN	103	140	BUY

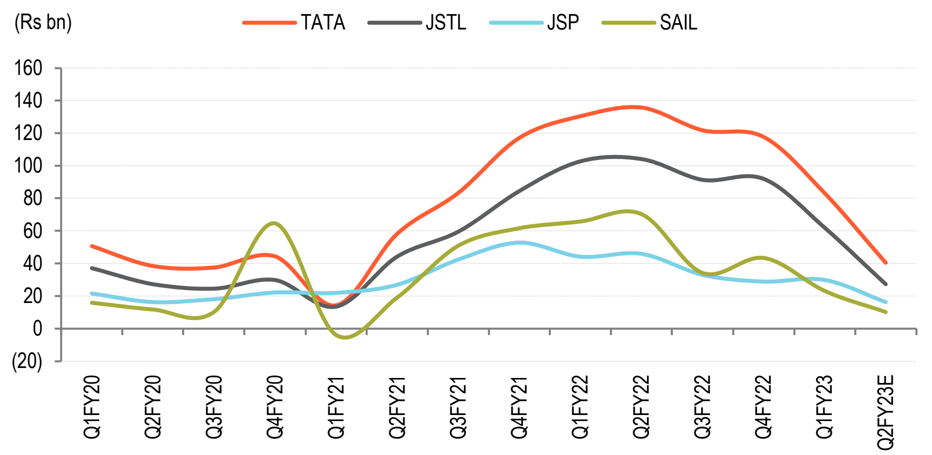
Price & Target in Rupees | Price as of 10 Oct 2022

Fig 1 – BOBCAPS Ferrous universe: Q2FY23 estimates

	Unit	TATA India	JSTL India	JSP India	SAIL	4 Majors – India	TATA Europe
Operations							
Production	mt	4.8	5.4	1.9	4.298	16.4	2.4
QoQ	%	(2.3)	(3.4)	(4.5)	(0.8)	(2.5)	(1.6)
Sales	mt	4.9	5.3	1.8	4.2	16.2	1.9
QoQ	%	20.8	17.5	3.4	33.2	20.4	(12.1)
Per tonne							
Revenue/t	Rs'000/t	69.9	64.6	62.8	65.2	66.2	103.0
QoQ	Rs'000/t	(13.8)	(13.8)	(11.0)	(11.0)	(12.7)	(18.3)
EBITDA/t	Rs'000/t	8.3	4.2	8.8	2.4	5.5	8.5
QoQ	Rs'000/t	(12.0)	(8.2)	(7.6)	(4.9)	(8.6)	(19.7)
Financials – Indian operations							
Revenue	Rs bn	343.2	342.5	113.1	273.8	1,072.6	193.7
QoQ	%	0.9	(3.1)	(12.0)	13.9	1.0	(25.4)
EBITDA	Rs bn	40.9	22.2	15.9	10.2	89.1	15.9
QoQ	%	(50.6)	(60.2)	(44.4)	(55.8)	(53.1)	(73.6)
Financials – Consolidated operations							
Revenue	Rs bn	567.8	372.5	114.8	273.8	1329.0	-
QoQ	%	(10.5)	(2.2)	(12.0)	13.9	(4.1)	-
EBITDA	Rs bn	54.7	27.2	16.4	10.2	108.4	-
QoQ	%	(61.9)	(56.0)	(45.1)	(55.8)	(53.1)	-
Net profit	Rs bn	18.5	(1.8)	5.5	0.1	22.3	-
QoQ	%	(76.1)	(122.1)	(72.2)	(98.4)	(82.8)	-

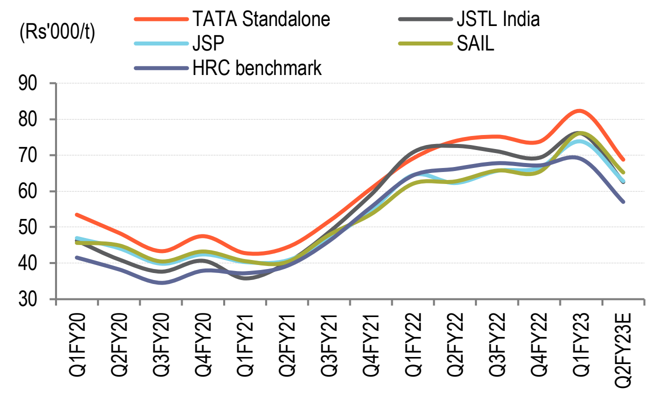
Source: Company, BOBCAPS Research

Fig 2 – Q2 consolidated EBITDA to drop more than 50% QoQ



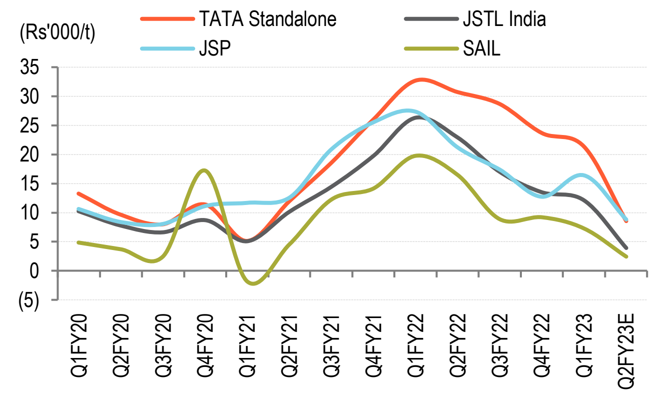
Source: Company, BOBCAPS Research

Fig 3 – Steep decline in realisation…



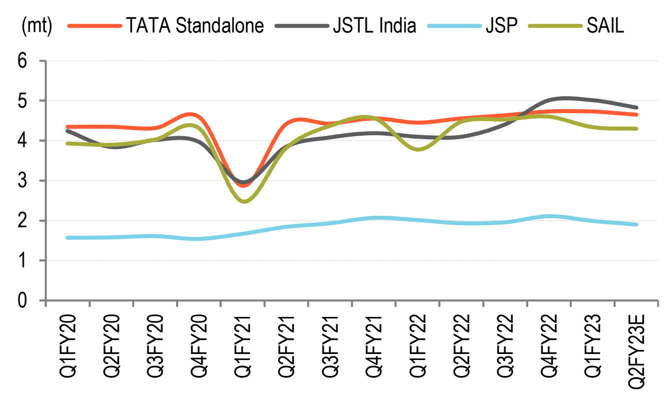
Source: Company, BOBCAPS Research

Fig 4 – …forecast to drive EBITDA/t below mid-cycle levels



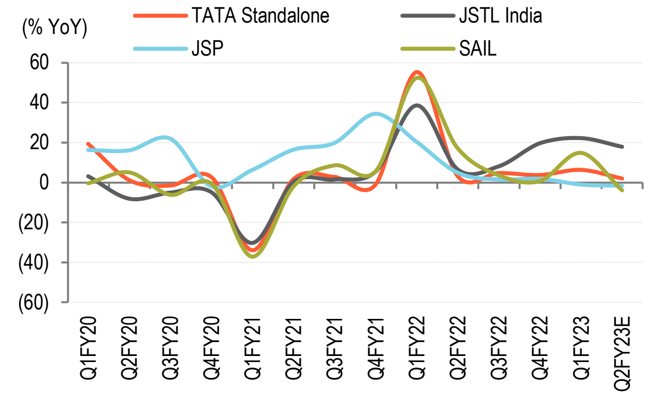
Source: Company, BOBCAPS Research

Fig 5 – Production muted with inventory overhang



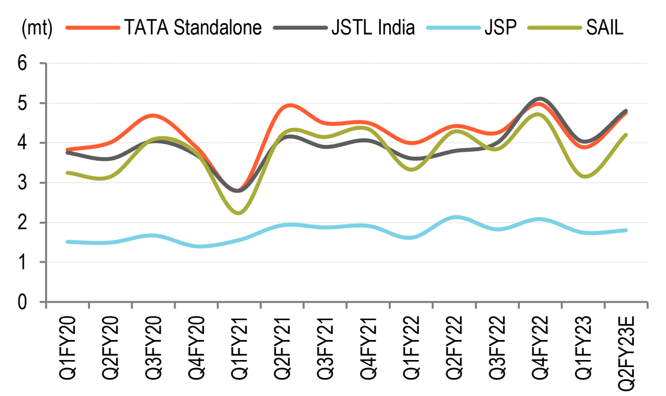
Source: Company, BOBCAPS Research

Fig 6 – Production growth YoY



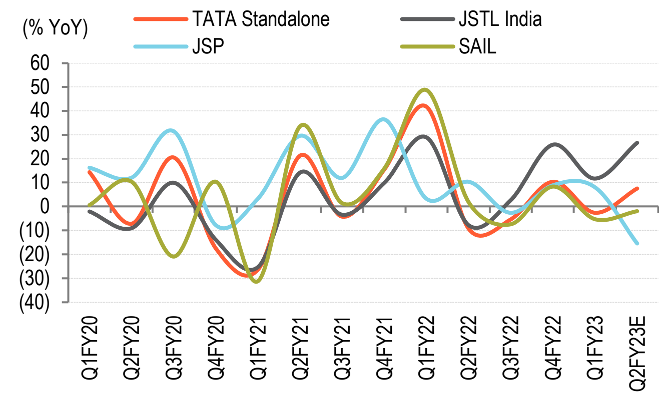
Source: Company, BOBCAPS Research

Fig 7 – Sales revival from June lows but inventory normalisation at least a quarter away



Source: Company, BOBCAPS Research

Fig 8 – Sales growth YoY



Source: Company, BOBCAPS Research

Disclaimer

Recommendation scale: Recommendations and Absolute returns (%) over 12 months

BUY – Expected return >+15%

HOLD – Expected return from -6% to +15%

SELL – Expected return <-6%

Note: Recommendation structure changed with effect from 21 June 2021

Our recommendation scale does not factor in short-term stock price volatility related to market fluctuations. Thus, our recommendations may not always be strictly in line with the recommendation scale as shown above.

Rating distribution

As of 30 September 2022, out of 119 rated stocks in the BOB Capital Markets Limited (BOBCAPS) coverage universe, 67 have BUY ratings, 30 have HOLD ratings, 5 are rated ADD*, 1 is rated REDUCE* and 16 are rated SELL. Of these, 2 companies rated BUY and 1 rated ADD have been investment banking clients in the last 12 months. (*Our ADD and REDUCE ratings are in the process of being migrated to the new recommendation structure.)

Analyst certification

The research analyst(s) authoring this report hereby certifies that (1) all of the views expressed in this research report accurately reflect his/her personal views about the subject company or companies and its or their securities, and (2) no part of his/her compensation was, is, or will be, directly or indirectly, related to the specific recommendation(s) or view(s) in this report. Analysts are not registered as research analysts by FINRA and are not associated persons of BOBCAPS.

General disclaimers

BOBCAPS is engaged in the business of Stock Broking and Investment Banking. BOBCAPS is a member of the National Stock Exchange of India Limited and BSE Limited and is also a SEBI-registered Category I Merchant Banker. BOBCAPS is a wholly owned subsidiary of Bank of Baroda which has its various subsidiaries engaged in the businesses of stock broking, lending, asset management, life insurance, health insurance and wealth management, among others.

BOBCAPS's activities have neither been suspended nor has it defaulted with any stock exchange authority with whom it has been registered in the last five years. BOBCAPS has not been debarred from doing business by any stock exchange or SEBI or any other authority. No disciplinary action has been taken by any regulatory authority against BOBCAPS affecting its equity research analysis activities.

BOBCAPS has obtained registration as a Research Entity under SEBI (Research Analysts) Regulations, 2014, having registration No.: INH000000040 valid till 03 February 2025. BOBCAPS is also a SEBI-registered intermediary for the broking business having SEBI Single Registration Certificate No.: INZ000159332 dated 20 November 2017. BOBCAPS CIN Number: U65999MH1996GOI098009.

BOBCAPS prohibits its analysts, persons reporting to analysts, and members of their households from maintaining a financial interest in the securities or derivatives of any companies that the analysts cover. Additionally, BOBCAPS prohibits its analysts and persons reporting to analysts from serving as an officer, director, or advisory board member of any companies that the analysts cover.

Our salespeople, traders, and other professionals may provide oral or written market commentary or trading strategies to our clients that reflect opinions contrary to the opinions expressed herein, and our proprietary trading and investing businesses may make investment decisions that are inconsistent with the recommendations expressed herein. In reviewing these materials, you should be aware that any or all of the foregoing, among other things, may give rise to real or potential conflicts of interest. Additionally, other important information regarding our relationships with the company or companies that are the subject of this material is provided herein.

This material should not be construed as an offer to sell or the solicitation of an offer to buy any security in any jurisdiction where such an offer or solicitation would be illegal. We are not soliciting any action based on this material. It is for the general information of BOBCAPS's clients. It does not constitute a personal recommendation or take into account the particular investment objectives, financial situations, or needs of individual clients. Before acting on any advice or recommendation in this material, clients should consider whether it is suitable for their particular circumstances and, if necessary, seek professional advice.

The price and value of the investments referred to in this material and the income from them may go down as well as up, and investors may realize losses on any investments. Past performance is not a guide for future performance, future returns are not guaranteed and a loss of original capital may occur. BOBCAPS does not provide tax advice to its clients, and all investors are strongly advised to consult with their tax advisers regarding any potential investment in certain transactions — including those involving futures, options, and other derivatives as well as non-investment-grade securities —that give rise to substantial risk and are not suitable for all investors. The material is based on information that we consider reliable, but we do not represent that it is accurate or complete, and it should not be relied on as such. Opinions expressed are our current opinions as of the date appearing on this material only. We endeavour to update on a reasonable basis the information discussed in this material, but regulatory, compliance, or other reasons may prevent us from doing so.

We and our affiliates, officers, directors, and employees, including persons involved in the preparation or issuance of this material, may from time to time have "long" or "short" positions in, act as principal in, and buy or sell the securities or derivatives thereof of companies mentioned herein and may from time to time add to or dispose of any such securities (or investment). We and our affiliates may assume an underwriting commitment in the securities of companies discussed in this document (or in related investments), may sell them to or buy them from customers on a principal basis, and may also perform or seek to perform investment banking or advisory services for or relating to these companies and may also be represented in the supervisory board or any other committee of these companies.

For the purpose of calculating whether BOBCAPS and its affiliates hold, beneficially own, or control, including the right to vote for directors, one per cent or more of the equity shares of the subject company, the holdings of the issuer of the research report is also included.

BOBCAPS and its non-US affiliates may, to the extent permissible under applicable laws, have acted on or used this research to the extent that it relates to non-US issuers, prior to or immediately following its publication. Foreign currency denominated securities are subject to fluctuations in exchange rates that could have an adverse effect on the value or price of or income derived from the investment. In addition, investors in securities such as ADRs, the value of which are influenced by foreign currencies, effectively assume currency risk. In addition, options involve risks and are not suitable for all investors. Please ensure that you have read and understood the Risk disclosure document before entering into any derivative transactions.

In the US, this material is only for Qualified Institutional Buyers as defined under rule 144(a) of the Securities Act, 1933. No part of this document may be distributed in Canada or used by private customers in the United Kingdom.

No part of this material may be (1) copied, photocopied, or duplicated in any form by any means or (2) redistributed without BOBCAPS's prior written consent.

Company-specific disclosures under SEBI (Research Analysts) Regulations, 2014

The research analyst(s) or his/her relatives do not have any material conflict of interest at the time of publication of this research report.

BOBCAPS or its research analyst(s) or his/her relatives do not have any financial interest in the subject company. BOBCAPS or its research analyst(s) or his/her relatives do not have actual/beneficial ownership of one per cent or more securities in the subject company at the end of the month immediately preceding the date of publication of this report.

The research analyst(s) has not received any compensation from the subject company or third party in the past 12 months in connection with research report/activities. Compensation of the research analyst(s) is not based on any specific merchant banking, investment banking or brokerage service transactions.

BOBCAPS or its research analyst(s) is not engaged in any market making activities for the subject company.

The research analyst(s) has not served as an officer, director or employee of the subject company.

BOBCAPS or its associates may have material conflict of interest at the time of publication of this research report.

BOBCAPS's associates may have financial interest in the subject company. BOBCAPS's associates may hold actual / beneficial ownership of one per cent or more securities in the subject company at the end of the month immediately preceding the date of publication of this report.

BOBCAPS or its associates may have managed or co-managed a public offering of securities for the subject company or may have been mandated by the subject company for any other assignment in the past 12 months.

BOBCAPS may have received compensation from the subject company in the past 12 months. BOBCAPS may from time to time solicit or perform investment banking services for the subject company. BOBCAPS or its associates may have received compensation from the subject company in the past 12 months for services in respect of managing or co-managing public offerings, corporate finance, investment banking or merchant banking, brokerage services or other advisory services in a merger or specific transaction. BOBCAPS or its associates may have received compensation for products or services other than investment banking or merchant banking or brokerage services from the subject company in the past 12 months.